



Opinions

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China's Supply-side Structural Reforms for Sustainable Growth in the New Normal Era



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One of the key words of the Chinese economy in 2018 is "supply-side structural reform" (SSSR). China's economic growth rate reached 6.9% in 2017, rebounding for the first time since entering the New Normal (新常态)¹ era of China, and climbing higher than previous forecasts by international institutes. The Chinese government held a briefing on how SSSR is one of the main causes of good performance, and presented to implement SSSR as one of its key tasks in 2018 at the Central Economic Work Conference, held in December 2017.

Supply-side structural reform is an unfamiliar term not found in economics. It refers to one of the macroeconomic policies of the Xi Jinping administration that have been employed since November 2015. China's

¹ The Chinese new normal proposed by Pr. Xi Jinping in 2014 is different from the new normal proposed by El Erian, the former CEO of PIMCO. As the new normal in the United States is a new standard of low growth, low income, and low yield after the global financial crisis, the Chinese new normal is an effort to change the paradigm of growth so that growth rate targets are lowered and sustainable growth is guaranteed through upgrading the economic structure.

supply-side reform largely differs in their background and implementation from Reaganomics, which was based on the supply-side economic policies carried out by the United States in the 1980s.

The background of SSSR is related with the Chinese economic development model and its macroeconomic policy. After the reform and opening up, the Chinese economy was able to achieve rapid growth by playing the role of the global manufacturing factory, producing and exporting low added-value products by combining the low wage labor force of China and foreign capital and technology. Also, the Chinese government faithfully carried out fiscal and monetary policies to adjust aggregate demand, based on the theory of Keynesian economics. However, while the global factory model and macroeconomic policies to adjust aggregate demand may be beneficial to the quantitative growth of the economy, the elements of qualitative growth — such as the enhancement of corporate technology and competitiveness, human capitalization of labor force, and creation of new growth engines — have failed to achieve great development.

In response to the global financial crisis in 2008, the Chinese government implemented large-scale expansionary monetary and fiscal policies. At this time, the capital released on the market came to be concentrated on state-owned enterprises (SOEs) in real estate and infrastructure, which do not contribute to the qualitative development of the Chinese economy, thus exacerbating structural problems. In this process, overcapacity in some sectors, such as the steel and coal industry and real estate, has created a transmission mechanism from serious overcapacity, drop in yield, surging debt and finally to financial risk that seems to threaten the national economy. These developments have led to Western economies raising the view that the Chinese economy is likely to fall into a middle-income trap, and this pessimistic view of a Chinese economic crisis has spread.

Under these complex and difficult circumstances, the Chinese government needed to reestablish its economic policies for the New Normal era, and it became necessary to propose a solution to the middle-income trap, as referred to by Western economists. The Chinese government recognizes that an economic stimulus package focused on aggregate demand will further deepen the existing structural contradictions, such as expansion of the inefficient state-owned sector, expansion of real estate stocks and overlapped investment in infrastructure. In addition, the Chinese government acknowledged that it has entered the era of New Normal, referring to the medium-speed growth it has seen from 2012, and declared that it would not use artificial stimulus measures, while emphasizing that state-owned sectors in-

cluding SOEs, local governments, and state-owned commercial banks were needed to adapt to the medium-speed growth era, and in this process SSSR was proposed.

According to economics theory and experience from the Western countries, on the supply-side there are few macroeconomic policy tools implemented by the government. Since the main players in supply are the households and firms, the government plays an indirect and long-term role, such as tax reduction, deregulation, education and R&D policies. In contrast, the Chinese government can control the public sector, which plays a leading role in the Chinese economy. In other words, the distribution of production factors such as land, resources, capital, technology and institution can be distributed according to the directions and strategies of the Chinese government. In this sense, SSSR is a macroeconomic policy frame created by the Chinese government based on the Chinese economic reality, which was not foreseen in any existing economic theory.

The objective of SSSR is to reduce ineffective and low-end supply, and expand effective and middle-high end supply to meet the market demand through improvements in productivity realized by the efficient allocation of production factors. This allows China to shift from a factor input-driven model to an innovation-driven growth model and preventing the transfer of real sector problems to financial risks. To achieve these goals, all measures related to the improvement of supply productivity can be included in the contents of SSSR such as monetary and fiscal policy, real estate, population, education, R&D, financial system reform, administrative simplification and corporate cost reduction.

As such, there is a wide range of content related to SSSR, regarding which the Chinese government has placed priority on the urgent fields that have a big impact on the macroeconomic economy or are likely to transfer to financial risks. From 2016 to 2017, China implemented supply-side reform, focusing on its five main tasks (3 去 1 降 1 補), which are cutting overcapacity, destocking property inventory, corporate deleveraging, lowering corporate costs, and improving weak links. As the supply-side reforms have been successful in reducing overcapacity and destocking property over the past two years, the main tasks in 2018 are adjusted into three tasks (破立降), which are eliminating ineffective supply (破), creating new growth engines (立) and lowering real-sector costs (降). Specific details of supply-side reform will be adjusted in accordance with the progress and economic situation in the future.

To simplify, the supply-side reform will proceed in two stages. In the short term, it is likely to focus on reducing inefficient supply such as eliminating zombie companies through cutting

overcapacity and corporate deleveraging. These problems are also related with transfer into financial risks. In the long term, the focus will be more on expanding efficient supply such as tax reduction for lowering corporate cost, deregulation and creation of new growth engines, which are in line with supply-side economics like Reaganomics.

So far, the Chinese government's diagnosis of the Chinese economy and prescriptions for short-term issues in the new normal era seem appropriate. And as the second five-year term of Pr. Xi Jinping has started, it is expected that SSSR will be carried out more intensively. However, the reforms of SSSR over the past two years have been used by the Chinese government in the past to solve overcapacity of SOEs, real estate problems, and SOE reform. The key to success or failure of SSSR is whether the global competitiveness of SOEs is enhanced, whether the efficiency of production factors is enhanced and whether new growth engines are created. Furthermore, the mass unemployment problem in the process of eliminating zombie companies, and the ability to attract the cooperation of SOEs and local governments, seems to be a real challenge for SSSR. If supply-side reforms proceed appropriately, China's economy in the new normal era will take another leap forward, which will provide an opportunity to shift from a catch-up strategy to an innovative leading country. **KIEP**